Audit Report

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE DOD AGENCY-WIDE FINANCIAL STATEMENTS FOR FY 1998

Report Number 99-097

March 1, 1999

Office of the Inspector General
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Acronyms

CFO	Chief Financial Officers
DFAS	Defense Finance and Accounting Service
FFMIA	Federal Financial Management Improvement Act of 1996
FMFIA	Federal Managers' Financial Integrity Act of 1992
GPRA	Government Performance and Results Act of 1993
IG	Inspector General
OMB	Office of Management and Budget
PP&E	Property, Plant, and Equipment
SAS	Statement on Auditing Standards
SFFAS	Statements of Federal Financial Accounting Standards
USD(C)	Under Secretary of Defense (Comptroller)
USGSGL	U.S. Government Standard General Ledger
WCF	Working Capital Fund

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March 1, 1999

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the DoD Agency-wide Financial Statements for FY 1998 (Report No. 99-097)

We are providing this report for your information and use. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare annual financial statements. We conducted this audit in accordance with Government auditing standards and the requirements of Office of Management and Budget Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999. This Bulletin requires the Inspector General, DoD, to express an opinion on the DoD financial statements and to report on the adequacy of internal controls and compliance with laws and regulations.

We were unable to express an opinion on the DoD Agency-wide Financial Statements for FY 1998 because DoD did not provide the financial statements in time for us to perform all the necessary audit work and because internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist. This report discusses material weaknesses and reportable conditions which were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 1998, the DoD Annual Statement of Assurance for FY 1998, and the DoD Biennial Financial Management Improvement Plan. Our disclaimer of opinion on the DoD Agency-wide Financial Statements for FY 1998 is at Exhibit 3.

We appreciate the courtesies extended to the audit staff. If you have any questions, please contact Mr. Richard B. Bird at (703) 604-9175 (DSN 664-9175), e-mail rbird@dodig.osd.mil, or Mr. Jack Armstrong at (317) 510-3846 (DSN 699-3846), e-mail jarmstrong@dodig.osd.mil. See Appendix D for the report distribution.

David K. Steensma

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Report No. 99-097 **March 1, 1999**
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Internal Controls and Compliance With Laws and Regulations for the DoD Agency-wide Financial Statements for FY 1998

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare annual audited financial statements. This is the first in a series of reports related to the DoD Agency-wide Financial Statements for FY 1998.

The DoD Agency-wide Financial Statements for FY 1998 are compiled from the financial statements of the DoD reporting entities: the Army, Navy, and Air Force General Funds; the Army, Navy, Air Force, Defense Logistics Agency, and Defense Finance and Accounting Service Working Capital Funds; the Military Retirement Trust Fund; the U.S. Army Corps of Engineers, Civil Works Program; and financial data for the Other Defense Organizations General Fund and Working Capital Fund. In FY 1998, the DoD Components reported total assets of $606 billion, total liabilities of $976 billion, total net costs of operations of $260 billion, and total budgetary resources of $606 billion. We used data reported on the DoD Component financial statements for FY 1998 for our overall audit conclusions. The reported assets of DoD did not include approximately $618 billion of assets identified as National Defense Property, Plant, and Equipment. National Defense Property, Plant, and Equipment assets were included as supplementary stewardship information in the financial statements.

Audit Objectives. Our overall objective was to determine whether the DoD Agency-wide Financial Statements for FY 1998 were prepared in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended November 29, 1998. We also evaluated internal controls and compliance with laws and regulations.

Disclaimer of Opinion. DoD did not provide the DoD Agency-wide Financial Statements for FY 1998 in time for us to perform all of the necessary audit work. Therefore, we did not verify the reported amounts. However, we identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines within the Statement of Budgetary Resources. Those deficiencies would have precluded an audit opinion. We also identified $1.57 trillion in adjustments to financial data used to prepare financial statements for the Army General Fund, Army Working Capital Fund, Navy General Fund, Defense Logistics Agency, and Other Defense Organizations. Those adjustments were not supported by adequate audit trails or sufficient evidence to determine their validity.

The financial data reported on the FY 1998 Financial Statements for the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds;

the U.S. Army Corps of Engineers, Civil Works Program; the Defense Logistics Agency; and the Defense Finance and Accounting Service were unauditable and comprise a significant portion of the financial data reported on the DoD Agency-wide Financial Statements for FY 1998. Because the financial statements were not provided in a timely manner and because internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were unable to perform adequate audit tests of the various line item amounts reported on the financial statements. Therefore, we do not express an opinion on the DoD Agency-wide Financial Statements for FY 1998. The Department has initiated numerous actions to improve financial accounting, but the actions are not complete. The unqualified opinion on the Military Retirement Trust Fund is an example of positive accomplishments by DoD.

Review of Internal Controls. We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we do not express an opinion on DoD internal controls. DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 1998, the DoD Annual Statement of Assurance for FY 1998, and the DoD Biennial Financial Management Improvement Plan.

Review of Compliance With Laws and Regulations. Our objective was to assess compliance with laws and regulations related to the DoD Agency-wide Financial Statements for FY 1998 and not to express an opinion. The scope of our work was also limited because DoD did not provide us with financial statements in a timely manner, as required by the Chief Financial Officers Act of 1990. Therefore, we do not express an opinion on compliance with laws and regulations. DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. We identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996, the Chief Financial Officers Act of 1990, and the Federal Managers' Financial Integrity Act of 1982. In addition, we were not able to review the Government Performance and Results Act of 1993 performance measures as they related to the DoD Agency-wide Financial Statements for FY 1998.

Management Comments. The Deputy Chief Financial Officer commented that the Department did not have sufficient time to review and determine the validity of individual assertions in the report. The DoD has a two-track approach to improve financial management. The DoD is improving its current systems, but does not expect to have systems that produce auditable financial statements until 2003. The DoD has also undertaken an interim track by using contractors to address a number of financial management challenges that impact the DoD financial statements. Appendix C contains the full text of the comments.

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Introduction

Background

Reporting Requirements. Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires the DoD to prepare annual audited financial statements. In addition, the "Federal Financial Management Act of 1994" requires the Secretary of the Treasury, in coordination with the Director, Office of Management and Budget (OMB), to prepare Government-wide financial statements beginning in FY 1997. OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999, establishes the minimum requirements for audits of Federal financial statements. This is the first in a series of reports related to the DoD Agency-wide Financial Statements for FY 1998.

Accounting Functions and Responsibilities. The Under Secretary of Defense (Comptroller) (USD[C]), as the Chief Financial Officer (CFO), is responsible for overseeing all financial management activities related to the programs and operations of the DoD. The Defense Finance and Accounting Service (DFAS) performs accounting functions and prepares financial statements for DoD. DFAS operates under the control and direction of the USD(C). DFAS is responsible for entering information from DoD entities into finance and accounting systems, operating and maintaining the finance and accounting systems, and ensuring the continued integrity of the information entered. The DoD reporting entities are responsible for providing accurate financial information to DFAS through the feeder systems.

Internal Control Responsibilities. As the CFO, the USD(C) oversees all financial management activities for DoD programs and operations, including the accounting functions of DFAS. The Military Departments, Defense agencies, and DoD field activities are responsible for managing their operations. Establishing and maintaining internal controls appropriate to the entity is an important management responsibility. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and with any laws and regulations that OMB, DoD, or the Inspector General (IG), DoD, have identified as being significant and for which compliance can be objectively measured and evaluated.

Compliance Responsibilities. The CFO is also responsible for compliance with

laws and regulations applicable to the DoD Agency-wide financial statements. The Military Departments, Defense agencies, and DoD field activities are responsible for compliance with laws and regulations applicable to their organizations. Compliance with laws and regulations is an important management responsibility and is essential for proper financial reporting.

Accounting Policy. The DoD Agency-wide Financial Statements for FY 1998 were to be prepared in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended November 29, 1998. Footnote 1 to the financial statements discusses the significant accounting policies followed in preparing the financial statements.

Scope of DoD Operations. In employment and discretionary spending authority, DoD is the largest Government agency. In FY 1998, DoD employed about 2.2 million active-duty Service members and civilian personnel and about 886,000 reservists. In FY 1998, the DoD Components reported total assets of $606 billion, total liabilities of $976 billion, total net costs of operations of $260 billion, and total budgetary resources of $606 billion. The total DoD assets did not include approximately $618 billion of assets identified as National Defense Property, Plant, and Equipment (PP&E). National Defense PP&E assets were included as supplementary stewardship information in the financial statements.

Adequacy of DoD Guidance. DoD Regulation 7000.14-R, the "DoD Financial Management Regulation," Volume 6B, "Form and Content of the Department of Defense Audited Financial Statements" (DoD Form and Content guidance), December 29, 1998, prepared by the CFO, and DFAS reporting guidance, prepared by the Director, DFAS, were not adequate. The DoD Form and Content guidance did not adequately address reporting the elimination of intergovernmental transactions, and DFAS instructed its Centers to make forced entries so that accounting records would show balanced accounts.

Disclaimer of Opinion. DoD did not provide us with the FY 1998 Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Financing, Statement of Budgetary Resources, and Statement of Custodial Activity in time for us to perform all of the necessary audit work. Therefore, we did not verify the reported amounts. However, we identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines within the Statement of Budgetary Resources. Those deficiencies would have precluded an audit opinion. We also identified $1.57 trillion in adjustments to financial data used to prepare financial statements for the Army General Fund, Army Working Capital Fund, Navy General Fund, Defense Logistics Agency, and Other Defense Organizations. Those adjustments were not supported by adequate audit trails or sufficient evidence to determine their validity.

The financial data reported on the FY 1998 Financial Statements for the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; the U.S. Army Corps of Engineers, Civil Works Program; the Defense Logistics Agency; and the Defense Finance and Accounting Service were unauditable and comprise a significant portion of the financial data to be reported on the DoD Agency-wide Financial Statements for FY 1998.

Because the financial statements were not provided in a timely manner and internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were not able to perform adequate audit tests of the various line item amounts reported on the financial statements. As a result, we do not express an opinion on the DoD Agency-wide Financial Statements for FY 1998.

Objectives

Our overall audit objective was to determine whether the DoD Agency-wide Financial Statements for FY 1998 were presented fairly in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended November 29, 1998. As part of this objective, we determined whether internal controls were adequate to ensure that the DoD Agency-wide Financial Statements for FY 1998 were free of material error, and we assessed DoD compliance with laws and regulations for transactions and events that had a direct and material effect on the financial statements.

Review of Internal Controls

Overview of Material Weaknesses

Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal controls does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited, and would not be detected in a timely manner by employees in the normal course of performing their functions.

We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we do not express an opinion on the DoD internal controls. DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 1998 (Exhibit 1), the DoD Annual Statement of Assurance for FY 1998, and the DoD Biennial Financial Management Improvement Plan.

Statement on Auditing Standards (SAS) No. 82, "Consideration of Fraud in a Financial Statement Audit," February 1997, requires us to specifically assess the risk of material misstatement of the financial statements due to fraud and to consider that assessment in designing audit procedures to be performed. We included our assessment of fraud risk in our review of internal controls.

Internal Control Components

SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55," December 1995, revised the definition and description of internal controls in SAS No. 55. SAS No. 78 defined internal controls as a process performed by an entity's board of directors, management, or other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

SAS No. 55 had stated that the internal control structure was composed of three elements: control environment, accounting systems, and control procedures. SAS No. 78 amended this description by stating that internal controls consist of five interrelated components:

- the control environment,
- risk assessment,
- control activities,
- information and communication, and
- monitoring.

Control Environment

The control environment includes factors that set the tone of an organization, influencing the control consciousness of its employees. The control environment includes several organizational factors, such as management's philosophy and commitment to competence. The ability of DoD to prepare auditable financial statements would be improved if:

- DoD management prepared more complete plans to improve financial management processes and systems;
- DoD provided adequate and timely guidance to the DoD Components for preparing financial statements; and
- the CFO provided auditable and timely financial statements.

We identified similar problems with DoD financial reporting guidance and financial statements for FY 1997. A discussion of these issues was included in IG, DoD, Report No. 98-161, "Internal Controls and Compliance With Laws and Regulations for the DoD Consolidated Financial Statements for FY 1997," June 22, 1998, and IG, DoD, Report No. 98-210, "Compilation Process for the DoD Agency-wide Financial Statements for FY 1997," September 24, 1998.

Plans to Improve Financial Management. In memorandums issued during FY 1998, the President and the Secretary of Defense both stressed the importance of financial management and their commitment to addressing financial management problems. The President cited the Government's goal of achieving an unqualified audit opinion on its financial statements for FY 1999. The Secretary of Defense stated that "only by achieving favorable audit opinions on our financial statements can the Department restore its credibility with the public and ensure that we, as senior managers, are effectively carrying out our fiduciary responsibilities." However, several factors have shown that the DoD plans to improve financial management need to be more complete to meet the President's and Secretary's goals. Specifically:

- In the Biennial Plan, the CFO has not clearly and completely identified financial management problems and the initiatives under way to remedy those problems.

- The CFO Implementation Strategies are not yet completed and do not adequately provide for improvements to financial management systems.

DoD Biennial Financial Management Improvement Plan. Although the initial version of the Biennial Plan was a good start, the CFO did not clearly and completely identify financial management problems and the initiatives under way to remedy those problems. In response to the requirements of the National Defense Authorization Act of 1998 (the Authorization Act) and to meet existing requirements of the Federal Managers' Financial Integrity Act of 1982 (FMFIA), the CFO Act, and the FFMIA, the CFO prepared the first Biennial Plan for DoD. The Authorization Act required the Secretary of Defense to submit to Congress a biennial strategic plan for improving financial management within DoD. This plan was to address all aspects of financial management, including the finance, accounting, and feeder systems that support the financial functions of DoD. The Authorization Act included detailed requirements for statements of objectives, performance measures, schedules, and the identification of individual and organizational responsibilities for several special interest items.

We concluded in a prior report that the Biennial Plan was not fully responsive to the requirements of the Authorization Act and did not provide Congress and DoD managers with adequate information to plan, fund, and measure improvements to DoD financial management systems. More specifically, the Biennial Plan did not provide a clear and complete discussion of DoD financial management problems and the initiatives under way to remedy the problems, and did not fully address the special interest items identified in the Authorization Act. DoD recognized the need for improvement and is updating the Biennial Plan.

DoD Implementation Strategies. In May 1998, the CFO began developing Implementation Strategies to achieve a favorable opinion on the DoD Agency-wide Financial Statements for FY 1999. Implementation Strategies were developed for 14 areas that the CFO determined needed improvement. The CFO has approved 10 Implementation Strategies, including strategies for Fund Balance With Treasury; Military Retirement Health Benefits; and the existence, completeness, and valuation of PP&E assets. Three Implementation Strategies, for national defense PP&E, ammunition and munitions, and Operating Materials and Supplies, are pending; a strategy for Financing Payments was disapproved. The Implementation Strategies are commendable; however, the plans made by the CFO to achieve a favorable audit opinion do not adequately provide for improvements to financial management processes and systems.

DoD Form and Content Guidance. The DoD Form and Content guidance did not require adequate support for the intrafund eliminations included in Note 22. As result, the DoD Components reported over $76.1 billion in intra-agency revenues and $4.8 billion in intra-agency receivables that cannot be verified. This raises the question of the reliability of the earned revenues reported in the Statements of Net Cost and Accounts Receivable reported on the Balance Sheets. The DoD Form and Content guidance did not provide sufficient guidance on how to compile the financial statements and supporting footnotes. For example, with respect to eliminating entries, the guidance provided instructions on the format of Note 22, "Inter-Agency Eliminations." However,

the DoD Form and Content guidance did not explain how reporting entities should identify intragovernmental amounts that need to be eliminated at each level of the consolidation process. Further, the guidance was unclear about which types of eliminations should be included in Note 22. This uncertainty led to a reporting problem in Note 22 of the Army WCF Financial Statements for FY 1998. The DFAS Indianapolis Center, Indianapolis, Indiana, reported in Note 22 that $9.6 million in revenues with other Federal agencies should be eliminated at the Federal level but did not include amounts to be eliminated at the DoD Agency-wide level. The Army WCF reported $9.4 billion in total earned revenue on the Statement of Net Cost. However, we were unable to determine the amount of revenue earned from activities within DoD or outside Federal Government based on Note 22 information.

The DoD Form and Content guidance states that transactions with other Federal agencies should be identified in Note 22. However, the DoD Form and Content guidance also requires that the total amount of accounts receivable identified in Note 22 should be reconciled with intragovernmental accounts receivable. This reconciliation would require that Note 22 include both transactions with other DoD Components and other Federal agencies.

The inadequate DoD Form and Content guidance also affected the ability of the DFAS Columbus Center, Columbus, Ohio, to prepare the footnotes included in the DFAS WCF Financial Statements for FY 1998. Initially, DFAS Columbus Center personnel identified transactions with DLA to be eliminated as DFAS intrafund transactions. DFAS Columbus Center personnel were unsure whether to include in Note 22 amounts supporting intrafund eliminations and amounts from transactions with other DoD Components and other Federal agencies, or only those amounts from transactions with other Federal agencies.

Guidance Issued by DFAS. DFAS issued guidance to its personnel that impaired the ability of DoD to report credible information on the financial statements. DFAS issued the "FY 1998 CFO Act Reporting Schedule, Requirements, and Other Reference Information," on November 20, 1998. The DFAS reporting guidance gave DFAS personnel an interpretation of the latest OMB and DoD financial reporting guidance and instructions for preparing the DoD financial statements. The DFAS reporting guidance instructed personnel to take specific actions to avoid reporting any abnormal balances that may have occurred when reconciliations were made for purposes of elimination between accounts receivable and accounts payable, revenue and expense, and advances received and advances. The guidance told DFAS personnel to force the balances to agree, rather than reconcile any differences. Simple mathematical errors or a deeper accounting or reporting problem may cause abnormal balances. However, masking an abnormal balance, instead of researching and solving the problems, could lead to inaccurate and less credible reporting and fails to improve overall financial management.

Auditability of DoD Agency-wide Financial Statements. The CFO did not provide us with the DoD Agency-wide Financial Statements for FY 1998 in time for us to perform all of the necessary audit work. We relied on the line item totals of the DoD Components' financial statements for our audit procedures and conclusions. We examined internal controls over the DoD financial statement compilation process, and we identified internal control weaknesses and financial management deficiencies that impaired the ability of DoD to prepare auditable financial statements.

The late preparation of the financial statements occurred partially because the DoD Components did not receive OMB Bulletin No. 97-01 and the DoD Form and Content guidance in a timely manner. OMB finalized amendments to OMB Bulletin No. 97-01 on November 29, 1998. The CFO provided the DoD Form and Content guidance to the DoD Components on December 24, 1998, 3 months after the fiscal year-end and after the DoD Components had already begun preparing the financial statements. Thus, the DoD Components received guidance too late in the compilation process to react to the changes required to effectively prepare and accurately compile the financial statements.

Problems with the guidance and the availability of the financial statements were previously reported in our Disclaimer of Opinion on the DoD Consolidated Financial Statements for FY 1997 (included in the DoD published financial statements) and IG, DoD, Report No. 98-161, "Internal Controls and Compliance With Laws and Regulations for the DoD Consolidated Financial Statements for FY 1997," June 22, 1998. Until DoD improves its financial management and provides the auditors with timely financial statements, DoD will not be able to achieve favorable audit opinions.

Risk Assessment

For financial reporting purposes, an entity's risk assessment is its identification, analysis, and management of risks relevant to the preparation of financial statements following generally accepted accounting principles (or another comprehensive basis of accounting). DFAS did not adequately assess the risks of using a new financial management system to prepare financial statements and compile financial data for three DoD Components: the Army General Fund, the Army WCF, and Other Defense Organizations. These three DoD components are material to the DoD Agency-wide financial statements and account for $86.3 billion (14 percent) of the $607 billion in total assets reported by DoD Components. For FY 1998 financial reporting, the DFAS Indianapolis Center planned to use a new version of the Departmental Database-Direct Reporting system.

The new system, the Departmental Database-Direct Reporting system, was inoperable. Because implementation of this system had a low priority within DFAS, the DFAS Indianapolis Center did not have sufficient resources to ensure that the system was adequately tested using FY 1997 data and to develop contingency plans in the event that the system was inoperable. As a result, the DFAS Indianapolis Center developed an alternative desktop version of the Departmental Database-Direct Reporting system to prepare the Army General Fund and Army WCF Financial Statements for FY 1998. However, the Indianapolis Center was unable to use the alternative desktop version to compile financial data for the Other Defense Organizations General Fund and was forced to use a manual process. As a result, the financial statements and financial data were not available when required.

Control Activities and Information and Communication

Control activities are the various policies and procedures that help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Information and communication activities include the accounting system, consisting of the methods and records established to record, process, summarize, and report entity transactions and to maintain accountability of the related assets and liabilities. To be effective, the information and communication system must

identify and record all valid transactions; describe transactions on a timely basis; properly measure the value of transactions; record transactions in the proper time period; properly present and disclose transactions; and communicate responsibilities to employees. Control activities relate to procedural internal control activities, and information and communication activities are system-related internal control activities. During our review of DoD internal controls related to control activities and information and communication activities, we identified both procedural and system-related problems.

Procedural Problems. Procedural problems are tied predominantly to accounting and reporting procedures and the application of accounting and reporting standards, exclusive of DoD financial management systems. The DoD Biennial Plan acknowledged procedural problems that exist in DoD.

Accounting Adjustments. DFAS adjusted financial data to agree with various data sources and to add new data. DFAS made these adjustments without properly researching and reconciling differences between the accounting data and other data sources, or providing adequate audit trails. Adjustments to accounting data that are not properly supported by an audit trail indicate potential problems in DoD financial management systems. Without proper research, reconciliations, and audit trails, management's ability to support the financial data is impaired. Proper research, reconciliations, and audit trails are important internal control and management responsibilities addressed in Federal financial system requirements. We identified approximately $1.57 trillion in adjustments that were not supported by proper reconciliations or an adequate audit trail. These adjustments were made to the financial data for the Army General Fund, Army WCF, Navy General Fund, Other Defense Organizations General Fund, and the Defense Logistics Agency WCF.

Army General Fund. During the compilation of the Army General Fund Financial Statements for FY 1998, the DFAS Indianapolis Center made $673 billion in unsupported adjustments to force the general ledger to match the certified status data. The differences between the general ledger and status of funds information were not properly reconciled or researched.

Army WCF. The DFAS Indianapolis Center made over $104 billion in adjustments to Army WCF accounting data that did not have an audit trail to supporting documentation.

Navy General Fund. The DFAS Cleveland Center, Cleveland, Ohio, processed $773 billion in adjustments that forced amounts between budgetary and proprietary trial balances. These adjustments were initiated by the DFAS Cleveland Center to correct imbalances in budgetary trial balances for the Standard Accounting and Reporting System-Financial and Departmental Reporting. The DFAS Cleveland Center did not perform the proper reconciliations or research the imbalances to support the adjustments.

Other Defense Organizations General Fund. The DFAS Indianapolis Center made $18 billion of unsupported adjustments to the Other Defense Organizations accounting data. The DFAS Indianapolis Center made these adjustments to force accounting records to match U.S. Treasury records and to eliminate undistributed amounts that were not recorded in the accounting records. The differences between the accounting records and U.S. Treasury information were not properly reconciled and researched.

Defense Logistics Agency WCF. The DFAS Columbus Center did not research and resolve approximately $1 billion in differences between Defense Logistics Agency cash accounts and U.S. Treasury records. These adjustments were unsupported.

As a result of these adjustments, the DoD Agency-wide Financial Statements for FY 1998 were subject to a high risk of material misstatement. The lack of research, reconciliations, and audit trails impaired the auditors' ability to validate the adjustments. Problems with unsupported adjustments were also addressed in IG, DoD, Report No. 98-161.

Fund Balance With Treasury. The DoD Components and DFAS did not resolve differences between accounting data and various other data sources. For example:

- The account balance in the U.S. Army Corps of Engineers, Civil Works Program, Fund Balance With Treasury, did not agree with the account balance reported by the U.S. Treasury. The year-end difference between the Corps and U.S. Treasury balances was about $500 million. The Corps used the U.S. Treasury balance in its financial statements.

- The Army General Fund reported $29.5 billion in Fund Balance With Treasury, but DFAS and the Army did not research and resolve differences of $1.8 billion between accounting records and the U.S. Treasury balances.

- DLA reported $572.8 million in Fund Balance With Treasury; however, DFAS did not research and resolve approximately $1 billion in differences between DLA cash accounts and the U.S. Treasury records. Thus, we could not validate a significant portion of the DLA Fund Balance With Treasury.

Problem Disbursements. DoD has difficulties with its complex and inefficient payment processes and systems. DFAS has made significant progress in reducing in-transit disbursements and has reported progress in reducing the dollar values of problem disbursements; however, as of FY 1998, DoD reported $20 billion (absolute value) of problem disbursements and in-transit disbursements. The lack of integrated finance and accounting systems caused disbursing stations to make disbursements that were accounted for by stations that were not collocated with the disbursing stations. Problem disbursements occurred when the accountable station could not match the disbursement to the correct detailed obligation or when matching the disbursement to the corresponding obligation caused the total disbursement to exceed the amount of the recorded obligation. In-transit disbursements occurred when DoD reported a disbursement to the U.S. Treasury, but the disbursement was not received or was not processed by an accountable station. DFAS and the DoD Components have spent considerable time and effort reviewing the causes of problem disbursements and developing courses of action to reduce their creation. Problem disbursements and in-transit disbursements can increase the risks of:

- fraudulent or erroneous payments being made without detection,

- cumulative amounts of disbursements exceeding appropriated amounts and other legal spending limits, and
- inaccurate and unreliable financial reporting.

Further progress in reducing problem disbursements and in-transit disbursements is essential to meeting DFAS goals and improving the accuracy and reliability of financial reporting.

Military Retirement Health Benefits Liability. DoD continued to have problems with accurately reporting its Military Retirement Health Benefits Liability. For FY 1997, DoD did not provide current and complete information to the actuarial contractor responsible for calculating the $218 billion liability. Thus, the liability was unsupported and unreliable. In IG, DoD, Report No. 98-161, we discussed DoD problems with reporting the Military Retirement Health Benefits Liability.

For FY 1998, managers of the DoD Composite Health Care System did not provide claims and participant data to the Office of the Actuary, DoD, in time to estimate of the Military Retirement Health Benefits Liability for the DoD Agency-wide Financial Statements for FY 1998. Consequently, the Office of the Actuary, DoD, did not provide current and complete information to the actuarial contractor responsible for calculating the liability for FY 1998. The Office of the Actuary, DoD, adjusted the FY 1997 liability for inflation and reported the adjusted figure for FY 1998. Thus, the $223 billion reported value of the Military Retirement Health Benefits liability remained unsupported and unreliable for FY 1998.

Environmental Liabilities. DoD also had problems with accurately reporting Environmental Liabilities. For FY 1997, the DoD Components did not consistently report all environmental cleanup costs. We discussed DoD problems with reporting Environmental Liabilities in Report No. 98-161. For FY 1998, the data supporting the DoD Environmental Liabilities were not accurate, complete, or supportable because:

- DoD did not provide adequate criteria for reporting Environmental Liabilities;
- the process for estimating cleanup costs was not adequately documented;
- inconsistent cost estimating procedures were used; and
- significant liabilities for weapon system disposal and overseas cleanup were not included in the reported liability balance.

As a result, the $34.0 billion of Environmental Liabilities reported as part of the Other Liabilities line item on the DoD Agency-wide Financial Statements for FY 1998 was unreliable and likely to be materially understated.

System-Related Problems. System-related problems were tied predominantly to weaknesses in DoD financial management systems. The DoD Biennial Plan generally discussed many system-related problems that exist in DoD.

Accounts Receivable and Payable. DoD financial management systems were unable to properly record all accounts receivable and accounts payable. As a result, the amounts of Accounts Receivable and Accounts Payable were not reliable. Examples follow.

U.S. Army Corps of Engineers, Civil Works Program. Accounts receivable and accounts payable of $980 million each were materially understated. Accounts receivable did not have an allowance for estimated uncollectible amounts. Also, the U.S. Army Corps of Engineers Financial Management System did not:

- record long-term accounts receivable and long-term accounts payable, and
- estimate and record allowances for loss on accounts receivable and the corresponding bad debt expense.

The Corps needed to make changes to the financial management systems.

Navy WCF. Navy financial systems were not programmed to identify all intra-agency eliminations for accounts receivable. As a result, the Naval Audit Service was not able to verify intra-agency eliminations related to gross accounts receivable valued at $901.0 million.

Other Defense Organizations. The DFAS Indianapolis Center made unsupported adjustments of $7.8 billion to accounts payable and $3.8 billion to accounts receivable that resulted from adjustments to disbursements, collections, and canceling appropriations. As a result, the balances for accounts receivable and payable could not be relied on for Other Defense Organizations.

General Property, Plant, and Equipment. We were unable to audit the DoD general PP&E balance because of a lack of supporting documentation. SFFAS No. 6, "Property, Plant, and Equipment," November 30, 1998, requires Federal agencies to report the historical cost of general PP&E on their balance sheets. Accounting for most DoD general PP&E was accomplished without using DoD finance and accounting systems. DoD relied on facilities and logistics feeder systems to identify general PP&E and provide related information for financial reporting purposes. DoD feeder systems were not designed to capture, retain, and depreciate general PP&E. Also, DoD feeder systems were not able to supply supporting documentation for the value of general PP&E reported on the DoD Agency-wide Financial Statements for FY 1998. As a result, the total value of general PP&E reported by DoD Components, $128 billion, was unverifiable. To better define DoD problems with reporting general PP&E, the CFO has enlisted the services of a contractor to assist in developing a methodology for valuing general PP&E.

Army General Fund. The Army did not have adequate procedures and controls to ensure that the $8.9 billion reported for general equipment was accurate and complete. The Army formed a task force to establish a database of Army general equipment. However, the database was not completed in time to perform audit tests to verify the accuracy of the data.

U.S. Army Corps of Engineers, Civil Works Program. Real property reported at $25.5 billion on the financial statements was not reliable because of a net difference of $4 billion (absolute value of $6 billion) between general and subsidiary ledgers and because about 29,000 real property assets that were in the financial management system had no recorded book value.

Army WCF. The Army Audit Agency was unable to verify the $1.9 billion of PP&E reported by the Army WCF. The Army did not have documentation to support historical costs. In addition, Integrated Facilities System did not reconcile accounting data with property records, identify maintenance costs, and capitalize and depreciate real property for the Depot Maintenance business area.

Navy WCF. The Navy reported PP&E of $291 million for the Navy Supply Management business area. This amount could not be verified because property records were not transaction-based and a wall-to-wall inventory count was not performed.

Air Force General Fund. The Information Processing Management System, used to account for and report computer equipment valued at $1.2 billion, could not distinguish between equipment owned by the Air Force General Fund and the Air Force WCF. Consequently, the value of all Air Force computer equipment was included in the General PP&E line on the Air Force General Fund Balance Sheet.

Air Force WCF. A reported $2.8 billion of PP&E could not be verified because Air Force Depot Maintenance and Transportation Command systems did not account for or properly value all PP&E.

Defense Finance and Accounting Service WCF. A reported $46.2 million of fixed assets recorded in the general ledgers was not recorded in the subsidiary ledgers, and therefore could not be verified.

Defense Logistics Agency WCF. The DFAS Columbus Center may not have reported all existing and newly purchased capital assets in the $2.2 billion of PP&E reported on the financial statements.

Required Supplementary Stewardship Information. SFFAS No. 8, "Supplementary Stewardship Reporting," June 11, 1996 required that National Defense PP&E be removed form the balance sheet and reported as supplementary stewardship information. The stewardship information includes National Defense PP&E; Heritage Assets; and Stewardship Land. Based on initial versions of the DoD Components' financial statements, DoD will remove approximately $618.4 billion of assets from its Balance Sheet and reclassify it as stewardship assets because of a change in accounting standards effective in FY 1998. This information is not required to be audited. However, we applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with Federal accounting standards.

Inventory. DoD financial management systems were unable to accurately report inventory amounts on the DoD Agency-wide Financial Statements for FY 1998. DoD logistics feeder systems did not capture all of the inventory transactions processed and did not properly identify, record, and classify

transactions in accordance with Federal accounting standards. Thus, the $122 billion of Inventory and Related Property reported by the DoD Components for FY 1998 was unreliable. Inventory reporting problems will not be corrected until problems with DoD logistics feeder systems are fully identified and corrected.

Army WCF. The $10.5 billion in inventory reported by the Army could not be relied on. The Army Audit Agency identified the following internal control deficiencies:

- Accounting systems could not properly value Inventory Held for Repair. The Army used logistics records to determine the value of Inventory and Related Property and adjusted its accounting records by about $3.1 billion to agree with logistics data without reconciling them. The Army and DFAS did not perform research to determine the cause of the difference. The Army Audit Agency determined that the logistics records were not always accurate.

- The Army WCF reported $595 million for inventory in-transit from procurement that could not be verified. The Army did not account for inventory in-transit using actual acceptance procedures. In-transit inventory was computed by comparing disbursements and receipt data.

- DoD financial management systems were unable to accurately report Government-furnished material to contractors on the DoD Agency-wide Financial Statements for FY 1998. For example, the Army logistics feeder systems did not accurately identify consumable material in the possession of contractors. As a result, the $630 million of Government-furnished material reported for the Army was unverifiable.

Navy WCF. Inventory records were inaccurate because of errors in processing and reporting inventory transactions. The value of inventory and related property was inaccurate because inaccurate rates were used to value Excess, Obsolete, and Unserviceable Inventory; inaccurate rates were used to value Inventory Held for Repair; and weaknesses existed in the standard operating procedures for execution of the Inventory Valuation Model. In addition, Operating Materials and Supplies reported at $542.7 million was not revalued to the Navy at historical cost.

Air Force WCF. The Air Force Audit Agency could not verify $18 billion of inventory because Air Force supply systems were unable to account for and properly value inventory.

Defense Logistics Agency WCF. The methodology used to estimate the historic cost of ending inventories reported at $9.8 billion was not documented. In addition, DLA did not implement a sound statistical sampling plan to measure the dollar accuracy of inventory stored at the distribution depots.

Other Liabilities. Navy financial systems were not programmed to identify all intra-agency eliminations for unearned revenue. As a result, the Naval Audit Service was not able to verify intra-agency eliminations related to gross unearned revenue valued at $953.2 million.

Year 2000 Efforts in DoD. The year 2000 (Y2K) problem is the term used to describe the potential failure of information technology systems to process or perform date-related functions before, on, or after the turn of the century. Because of the potential failure of computers to run or function throughout the Government, the President issued an Executive Order, "Year 2000 Conversion," February 4, 1998, making it policy that Federal agencies ensure that no critical Federal program experiences disruption because of the Y2K problem. The Executive Order also requires the head of each agency to ensure that efforts to address the Y2K problem receive the highest priority in the agency. The Secretary of Defense assessed that high risk exists within DoD with respect to the Y2K problem. Although progress has been made, DoD still faces challenges in completing the Y2K conversion effort.

DFAS is required to prepare contingency plans with continuing operations alternatives for systems affected by the Y2K problem. The DFAS Y2K conversion is not complete; however, DFAS has placed a high priority on Y2K contingency planning and has issued contingency planning guidance. This guidance should improve the reliability and consistency of system-level contingency plans. DFAS has also made progress in application testing during the validation phase.

Monitoring

Monitoring assesses the quality of internal control performance over time and involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Monitoring activities are accomplished through ongoing activities, separate evaluations, or a combination of the two.

DoD conducted significant monitoring activities during FY 1998. DoD prepared the Biennial Plan and the Implementation Strategies to identify and address financial management problems and the remedies in place to solve those problems.

The Biennial Plan, which continues to evolve, did not provide a clear and complete discussion of DoD financial management problems and the initiatives under way to remedy those problems. The Biennial Plan could be improved if it identified the deficiencies for each financial management system and disclosed the remedies, resources, and milestones necessary to improve DoD financial management systems. DoD efforts were a step in the right direction and are continuing. We are working with personnel from the Office of the USD(C) to ensure that future versions of the Biennial Plan are improved.

IG, DoD, Report No. 98-210, "Compilation Process for the DoD Agency-wide Financial Statements for FY 1997," September 24, 1998, stated that the compilation process did not result in consistent, accurate, or complete financial reporting. Inconsistent reporting has been a recurring problem. We determined that the primary cause of the inconsistent, inaccurate, and incomplete reporting was the inability of DFAS to perform adequate reviews and reconciliations while preparing the financial statements. These reviews and reconciliations are a key monitoring activity that help to identify deep-rooted problems in financial management and reporting. Implementation and consistent use of these reviews and reconciliations will improve the ability of DoD to identify and solve problems and produce auditable financial statements.

Assessment of Fraud Risk

SAS No. 82 requires us to specifically assess the risk of material misstatement of the DoD Agency-wide Financial Statements for FY 1998 due to fraud, and to consider that assessment in designing audit procedures to be performed. SAS No. 82 describes two types of fraud that are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent reporting and misstatements arising from misappropriation of assets. For each of the two types of fraud, SAS No. 82 identifies fraud risk factors that auditors should consider.

Misappropriation of Assets

Risk factors for misappropriation of assets included:

- large amounts of cash on hand or processed;
- inventory characteristics, such as small size, high volume, or high demand;
- lack of appropriate management oversight;
- inadequate recordkeeping;
- lack of appropriate segregation of duties or independence checks;
- lack of an appropriate system for authorization and approval of transactions;
- poor physical safeguards over assets; and
- lack of timely and appropriate documentation for transactions.

All audits conducted by the IG, DoD, include steps to provide reasonable assurance of detecting fraud or other illegal acts. Any suspected instances of fraud or other illegal acts are coordinated with the Defense Criminal Investigative Service. Most of these referrals involve misappropriation of assets. In February 1999, the Defense Criminal Investigative Service had 80 open cases that involved DoD financial operations.

We were unable to determine the effects of these fraud investigations on the DoD Agency-wide Financial Statements for FY 1998. However, these investigations demonstrated that DoD was vulnerable to misappropriation of assets.

Fraudulent Financial Reporting

Fraudulent financial reporting risk factors included:

- motivation for management to engage in fraudulent financial reporting;
- failure of management to display and communicate an appropriate attitude regarding internal controls and the reporting process;

- excessive participation by nonfinancial management in selecting accounting principles or determining significant estimates;
- assets, liabilities, revenues, and expenses based on significant estimates that involved unusually subjective judgments or uncertainties;
- significant, unusual, or highly complex transactions or adjustments, especially those close to year-end, that posed difficult "substance over form" questions.

Based on our financial audits, we determined that many of the fraudulent financial reporting risk factors were present within DoD. For example:

- DFAS processed substantial unsupported year-end adjustments to prepare and ensure consistency in DoD financial statements.
- DoD reporting entities were unable to provide auditors with adequate audit trails linking financial statement data to supporting transaction-level data.
- DoD reporting entities were unable to demonstrate adequate accounting control over DoD assets.
- DoD financial management processes and systems were not adequate.

These examples are discussed in greater detail in this report in the sections on Control Environment and Control Activities and Information and Communication.

The presence of these risk factors did not necessarily indicate fraudulent financial reporting. However, the presence of these risk factors in DoD, combined with the fraud investigations conducted by the Defense Criminal Investigative Service, indicated an increased level of risk of material misstatements and that the control environment in DoD was susceptible to fraud. The existence of many of these fraud risk factors was due to the fact that financial reporting in DoD is an evolving process. Many existing nonfinancial procedures and systems are being adapted by DoD to fulfill more stringent financial management and reporting requirements.

Conclusion

Although considerable progress has been made, DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets, liabilities, costs, and budget resources were properly accounted for and reported. DoD financial reporting guidance was inadequate, and DoD did not provide the financial statements to the auditors by the required deadline. These problems are not new, but are recurring problems that DoD needs to address and correct.

The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 1998, the DoD Annual Statement of Assurance for FY 1998, and the DoD Biennial Financial Management Improvement Plan.

Management Comments

The Deputy Chief Financial Officer commented that the Department did not have time to review and determine the validity of assertions in the report. The Department does not expect to have systems necessary to produce auditable financial statements prior to 2003. Further, as an interim action, outside contractor support should help address a number of financial management challenges. The complete text of the comments is at Appendix C.

Review of Compliance With Laws and Regulations

Reportable Noncompliances

Reportable instances of noncompliance are failures to follow requirements, laws, or regulations that cause us to conclude that the aggregation of the misstatements resulting from those problems is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant.

Our objective was to assess the compliance with laws and regulations related to the DoD Agency-wide Financial Statements for FY 1998 and not to express an opinion. The scope of our work was limited because DoD did not provide us with financial statements in a timely manner, as required by the Chief Financial Officers Act of 1990. Therefore, we do not express an opinion on compliance with laws and regulations. DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. We identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996, the Chief Financial Officers Act of 1990, and the Federal Managers' Financial Integrity Act of 1982. In addition, we were not able to review the Government Performance and Results Act of 1993 (GPRA) performance measures as they related to the DoD Agency-wide Financial Statements for FY 1998.

Federal Financial Management Improvement Act of 1996

Under title 31, United States Code (U.S.C.) section 3512, the FFMIA, we are required to report whether the agency's financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards, and the USGSGL at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in OMB Bulletin No. 98-08.

The results of our tests disclosed instances where the agency's financial management systems did not substantially comply with the three requirements. The Military Departments, Defense agencies, and DFAS are collectively responsible for the financial management systems that support DoD. The Military Departments and Defense agencies are responsible for the nonfinancial data systems that supply approximately 80 percent of the data reported on the financial statements. These data are fed into the accounting and finance systems that are the responsibility of DFAS. DFAS used data from the financial management systems and other sources to compile the DoD Agency-wide Financial Statements for FY 1998. DoD identified at least 192 systems that were critical to financial management. Because it is impractical to report the deficiencies for all 192 systems, we have identified examples of the most significant system deficiencies in this report.

Federal Financial Management System Requirements. Federal financial management system requirements were established in OMB Circular No. A-127, "Financial Management Systems," July 23, 1993, which requires financial management systems to provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD and other Federal agencies must establish and maintain a single, integrated financial management system. In addition, the Joint Financial Management Improvement Program has published a series of "Federal Financial Management System Requirements" that establishes standard requirements for Federal agencies' integrated financial management systems. For FY 1998, the financial management systems that support DoD did not substantially comply with Federal financial management system requirements, as shown by the following:

- DoD did not have an integrated financial management system.
- Army, Air Force, and DFAS financial management systems did not maintain adequate audit trails and documentation requirements for journal entries.
- DFAS financial management systems did not selectively generate the transactions required for year-end closing procedures and the carryover of general ledger account balances.
- The Navy did not have an integrated financial management system from which to extract financial data for use in preparing financial statements.
- Many DoD feeder systems had significant deficiencies in general and application controls such as accreditation, configuration management, separation of duties, and access controls, and were unable to provide data that could be relied on for financial management reporting.

Federal Accounting Standards. Federal agencies reporting under the Federal Financial Management Act of 1994 are to follow the Statements of Federal Financial Accounting Standards (SFFAS) agreed to by the Director, OMB; the Comptroller General of the United States; and the Secretary of the Treasury. Currently, there are nine SFFAS and two Statements on Federal Financial Accounting Concepts. For FY 1998, the financial management systems that supported DoD did not substantially comply with Federal accounting standards, as follows:

- DoD financial management systems did not properly account for Accounts Receivable and Accounts Payable in accordance with SFFAS No. 2.
- DoD financial management systems and methodology for valuing inventory were not consistent with SFFAS No. 3.
- DoD financial management systems were unable to account for and report costs in accordance with SFFAS No. 5, particularly for intra-agency transactions.
- DoD financial management systems did not value and depreciate PP&E in accordance with SFFAS No. 6.

USGSGL at the Transaction Level. The OMB requires Federal agencies to implement the USGSGL in their financial systems. The USGSGL must be implemented at the transaction level. Federal agencies are permitted to supplement their application of the USGSGL to meet agency-specific information requirements. However, agency standard general ledgers must maintain consistency with the USGSGL. For FY 1998, DoD finance and accounting systems lacked a standard, transaction-driven general ledger because the USGSGL was not fully implemented throughout the systems. This deficiency was identified in the management representation letter.

DoD has also acknowledged that its financial management systems have significant procedural and systemic deficiencies, and has included a discussion of those deficiencies in previous Annual Statements of Assurance and the management representation letter for the DoD Agency-wide Financial Statements for FY 1998. In addition, in September 1998, DoD published the first Biennial Plan, which identified many impediments to achieving auditable financial statements, including financial management system deficiencies. The Biennial Plan was intended to be a strategic financial improvement plan that addressed financial management systems. However, the Biennial Plan did not identify specific remedial actions for financial management system deficiencies or time frames to implement such actions.

Chief Financial Officers Act of 1990

Title 31, U.S.C. section 501, the CFO Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare audited financial statements and submit them to OMB no later than March 1, 1999. In addition, the CFO Act requires DoD to prepare a Five-Year Financial Management Plan describing activities that DoD will conduct over the next 5 years to improve financial management. We did not receive the financial statements in sufficient time to conduct all of our necessary audit procedures and meet the OMB deadline. Further, the financial statements we received were unauditable. The Biennial Plan addressed the CFO Act requirement for a Five-Year Financial Management Plan.

Federal Managers' Financial Integrity Act of 1982

Title 31, U.S.C. section 65, the FMFIA, requires DoD to evaluate its systems of internal accounting and administrative controls to determine whether such systems can comply with the FMFIA, and to prepare an Annual Statement of Assurance for the President and the Congress stating whether DoD systems of internal accounting and administrative controls are in compliance with the FMFIA. DoD fulfilled part of the FMFIA requirement by including the discussion of financial management system deficiencies, usually published as part of the Annual Statement of Assurance, in its Biennial Plan. The Annual Statement of Assurance and the Biennial Plan discussed systemic and nonsystemic internal control weaknesses and corrective measures under way to correct the weaknesses. The Review of Internal Controls section of this report discusses the Biennial Plan and identifies several areas where DoD could improve its reporting of financial management problems. DoD and DFAS continued to identify financial management systems that were not compliant with FFMIA, OMB Circular No. A-127, and Y2K guidance. Although more details are needed in future plans, DoD improved its coverage of feeder system deficiencies for FY 1998 in the Biennial Plan.

Government Performance and Results Act of 1993

Title 31, U.S.C. section 1101, the GPRA, was enacted primarily to improve the confidence of the American people in the capability of the Federal Government by systematically holding Federal agencies accountable for achieving program results. DoD Form and Content guidance requires that DoD include a discussion of its GPRA performance measures, consistent with the DoD GPRA Performance Plan as published in the Annual Defense Report, in the Overview section of the DoD Agency-wide Financial Statements for FY 1998. The CFO did not provide the financial statements in a timely manner; as a result, we were not able to review the GPRA performance measures as they related to the DoD Agency-wide Financial Statements for FY 1998.

Conclusion

Noncompliance with laws and regulations affected the DoD Agency-wide Financial Statements for FY 1998. Many noncompliance issues were related to financial management system deficiencies and may not be fully corrected for a number of years. Other noncompliance issues were not specifically related to system deficiencies and should be correctable in the near future. All instances of noncompliance, including those not identified in this report, should be identified and addressed in the Biennial Financial Management Improvement Plan and related supporting documents, and DoD should plan for proper corrective actions. Improvements in compliance with laws and regulations are essential for DoD to improve financial management and reporting and will enhance the ability of DoD to achieve a favorable audit opinion.

Appendix A. Audit Process

Scope

Statements Reviewed. The CFO did not provide the DoD Agency-wide Financial Statements for FY 1998 in time for us to perform all of the necessary audit work. We were able to examine only the line item totals of the DoD Components' principal financial statements and footnotes provided by DFAS.

Scope Limitation. The CFO did not provide sufficient or reliable information for us to evaluate management's assertions or verify amounts on the DoD Agency-wide Financial Statements for FY 1998. The lack of financial statements is a scope limitation. Because of the scope limitation and accounting system and internal control deficiencies, the scope of our work was not sufficient to allow us to render an opinion on the DoD Agency-wide Financial Statements for FY 1998. To report on the internal controls and compliance with laws and regulations, we relied in part on audit work conducted by the Military Department audit agencies (the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency). Our combined audit efforts provide a reasonable basis for our results.

Accounting Principles. Accounting principles and standards for the Federal Government have been established and are under continuous development and refinement. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards for approval by the Director, OMB; the Secretary of the Treasury; and the Comptroller General. The Director, OMB, and the Comptroller General issue the standards after approval.

Agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01. The hierarchy includes standards agreed to and published by the Director, OMB, the Secretary of the Treasury, and the Comptroller General of the United States; interpretations of SFFAS issued by OMB; requirements for the form and content of financial statements outlined in OMB Bulletin No. 97-01; and accounting principles published by other authoritative sources.

Review of Internal Controls. In planning and performing our audit, we considered DoD internal controls over financial reporting by obtaining an understanding of the agency's internal controls. We determined whether the controls had been placed in operation; we assessed control risk; and we performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. Our purpose was not to provide assurance on internal controls over financial reporting. Consequently, we do not express an opinion on DoD internal controls.

In addition, we were unable to evaluate internal controls related to performance measures that would be normally reported in the Overview section of the DoD Agency-wide Financial Statements for FY 1998 because we did not receive the statements in a timely manner.

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls. Because of DoD material weaknesses in internal controls, we revised our audit approach to focus on specific internal controls. We obtained an understanding of management's process for evaluating and reporting on the internal controls and accounting systems and compared the material weaknesses in financial reporting, as reported in the entity's Annual Statement of Assurance, to the material weaknesses and reportable conditions we identified. A copy of this report will be provided to the USD(C), who is the senior official in charge of management controls for DoD.

We did not obtain an understanding of the design of internal controls relating to the existence and completeness assertions and whether they had been placed in operation. We did not review any GPRA performance measures as they related to the DoD Agency-wide Financial Statements for FY 1998 because the CFO did not provide the financial statements in a timely manner.

Review of Compliance With Laws and Regulations. DoD management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the DoD Agency-wide Financial Statements for FY 1998 were free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations. A reportable noncompliance could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 98-08. Our review also included the requirements referred to in the FFMIA. See Appendix B for a list of laws and regulations reviewed.

DoD-wide Corporate Level GPRA Goals. In response to GPRA, the DoD has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal:

> **Objective:** Fundamentally reengineer DoD and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals:

- **Financial Management Area Objective:** Reengineer DoD business practices. **Goal:** Standardize, reduce, clarify, and reissue financial management policies. **(FM 4.1)**
- **Financial Management Area Objective:** Strengthen internal controls. **Goal:** Improve compliance with FMFIA. **(FM 5.3)**

GAO High-Risk Area. The GAO has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

Auditing Standards. We conducted this financial statement audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD, and OMB Bulletin No. 98-08. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal statements present fairly, in all material respects, in conformity with Federal accounting standards, the assets, liabilities, and net position; net costs; changes in net position; budgetary resources; reconciliation of net costs to budgetary obligations; and if applicable, custodial activity. To assess the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses, we relied on the guidelines suggested by the General Accounting Office and on our professional judgment.

Audit Assistance. The Military Department audit agencies assisted us by auditing various reporting entities and accounts. Except for deficiencies unique to the consolidation process, the information in this report is a summary of the most significant issues reported by the IG, DoD, and the Military Department audit agencies.

Computer-Processed Data. We could not rely on the computer-processed data used to prepare the DoD Agency-wide Financial Statements for FY 1998. DoD financial management systems were unreliable; therefore, the financial statements were unauditable. DoD has candidly addressed deficiencies in its financial management systems in the Annual Statement of Assurance, the Biennial Plan, and the management representation letter for FY 1998. Unreliable computer-processed data were used in the preparation of the financial statements and this report because they were the only financial data available. We continue to review the adequacy of existing and proposed financial management systems.

Statistical Sampling Methods. We relied on information in audit reports and summaries and information in management reports. We did not use statistical sampling methods.

Audit Period and Locations. We conducted the audit from September 1998 through February 1999 at various DoD activities, including DFAS and the Military Departments.

Representation Letters. We received the management representation letter from the USD(C) on February 18, 1999, and the interim legal representation letter from the General Counsel, DoD, on January 4, 1999. Exhibit 1 is the management representation letter and Exhibit 2 is the legal representation letter.

Contacts During the Audit. We visited or contacted individuals and organizations in DoD. Further details are available on request.

Summary of Prior Coverage

The GAO and the IG, DoD, have conducted multiple reviews related to financial statement issues. GAO reports can be accessed on the Internet at http://www.gao.gov. IG, DoD, reports can be accessed on the Internet at http://www.dodig.osd.mil.

Appendix B. Laws and Regulations Reviewed

Public Law 104-208, "Federal Financial Management Improvement Act of 1996," September 30, 1996

Public Law 103-356, "Government Management Reform Act of 1994," October 13, 1994 (Title IV of this Act may be cited as the "Federal Financial Management Act of 1994")

Public Law 103-62, "Government Performance and Results Act of 1993," August 3, 1993

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 97-255, "Federal Managers' Financial Integrity Act of 1982," September 8, 1982

National Defense Authorization Act for FY 1998

OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended November 20, 1998

OMB Circular No. A-127, "Financial Management Systems," July 23, 1993

Statements of Federal Financial Accounting Concepts No. 1, "Objectives of Federal Financial Reporting," September 2, 1993

Statements of Federal Financial Accounting Concepts No. 2, "Entity and Display," June 6, 1995

Statements of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993

Statements of Federal Financial Accounting Standards No. 2, "Accounting for Direct Loans and Loan Guarantees," August 23, 1993

Statements of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," October 27, 1993

Statements of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government ," July 31, 1995

Statements of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995

Statements of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," November 30, 1995

Statements of Federal Financial Accounting Standards No. 7, "Accounting for Revenue and Other Financing Sources," May 10, 1996

Statements of Federal Financial Accounting Standards No. 8, "Supplementary Stewardship Reporting," June 11, 1996

Statements of Federal Financial Accounting Standards No. 9, "Deferral of the Effective Date of Managerial Cost Accounting Standards for the Federal Government in SFFAS No. 4," November 3, 1997

Joint Financial Management Improvement Program, "Framework for Federal Financial Management Systems," January 1995

Joint Financial Management Improvement Program, "Core Financial Systems Requirements," September 1995

Joint Financial Management Improvement Program, "Personnel/Payroll System Requirements," May 1990

Joint Financial Management Improvement Program, "Travel System Requirements," January 1991

Joint Financial Management Improvement Program, "Seized/Forfeited Asset System Requirements," March 1993

Joint Financial Management Improvement Program, "Direct Loan System Requirements," December 1993

Joint Financial Management Improvement Program, "Guaranteed Loan System Requirements," December 1993

Joint Financial Management Improvement Program, "Inventory System Requirements," June 1995

DoD Directive 5010.38, "Management Control Program," August 26, 1996

DoD Instruction 7000.14-R, "DoD Financial Management Policy and Procedures," various dates

Additional laws and regulations were identified and discussed in other IG, DoD, and Military Department audit agency reports used to develop this report.

Appendix C. Under Secretary of Defense (Comptroller) Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

FEB 23 1999

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING, OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Draft of a Proposed Audit Report on Internal Controls and Compliance with Laws and Regulations for the DoD Agency-wide Financial Statements for FY 1998 (Project No. 8FI-2024.02)

This is the Office of the Under Secretary of Defense (Comptroller) response to the subject draft report. The Department did not have sufficient time to review and determine the validity of the individual assertions in this report. Therefore, our comments are limited.

The Department of Defense (DoD) is committed to improving its financial management and to achieving unqualified audit opinions on its financial statements. The Department has adopted a two-track approach to address new federal-wide standards. The first track is to improve or replace its current systems so that they will meet new federal-wide standards. The Department does not expect to have systems necessary to produce auditable financial statements prior to the year 2003. To achieve progress before 2003, the Department has undertaken a second, interim track that includes the use of contractors to address most of its problems. As a result, the Department expects to make progress this year in addressing a number of financial management challenges that impact the DoD's and the Government's financial statements.

I appreciate the opportunity to review the audit report and expect that actions intended to improve the Department's financial management will lead to more favorable findings in future audits. My point of contact on this matter is Ms. Gretchen Anderson. She may be reached by e-mail: andersog@osd.pentagon.mil or by telephone at (703) 697-4691.

Nelson Toye

Nelson Toye
Deputy Chief Financial Officer

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
- Deputy Chief Financial Officer
- Deputy Comptroller (Program/Budget)

Under Secretary of Defense (Acquisition and Technology)
Assistant Secretary of Defense (Public Affairs)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, National Security Agency
- Inspector General, National Security Agency

Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
General Accounting Office
- National Security and International Affairs Division
  - Technical Information Center

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform

Exhibit 1. Management Representation Letter

COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAR 1 1999

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Management Assurance Concerning FY 1998 Department of Defense Agency-wide Financial Statements

This is in regard to your audit of the FY 1998 Department of Defense (DoD) Agency-wide Financial Statements (Project No. 8FI-2024). The financial statements include the Principal Statements (which are the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, the Statement of Custodial Activity, and the Notes to the Principal Statements) and the Required Supplementary Stewardship Information (RSSI), as of September 30, 1998. This memorandum provides assertions central to your determination of (1) an opinion as to whether the Principal Statements are presented fairly in all material respects, in conformity with federal accounting standards, and (2) whether the agency's financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards and the U.S. Government Standard General Ledger (SGL) at the transaction level as of September 30, 1998.

I confirm, to the best of my knowledge and belief, that the following representations are accurate as of the date of this letter, and pertain to the period covered by the principal financial statements.

1) I am responsible for the fair presentation of the FY 1998 DoD Agency-wide Principal Statements and RSSI in conformity with federal accounting standards.

2) The FY 1998 DoD Agency-wide Principal Statements and RSSI may not be presented in full conformity with federal accounting standards.

3) To the best of my knowledge, the Department has made available to you all financial records and related data, and communications from Office of Management and Budget (OMB) concerning noncompliance with or deficiencies in financial reporting practices.

4) I have no knowledge of material transactions that have not been properly recorded in the accounting records underlying the financial statements or disclosed in the notes to the financial statements that are not a matter of public record.

5) To the best of my knowledge, the Department of Defense has satisfactory title to all owned assets, including stewardship property, plant, and equipment; such assets

have no liens or encumbrances, nor have any assets been pledged, that are not a matter of public record.

6) I have no plans or intentions, other than those previously disclosed, that might materially affect the carrying value or classification of assets and liabilities.

7) To the best of my knowledge, guarantees under which the agency is contingently liable have been properly reported or disclosed.

8) Transactions for related parties (entities in which the Department has an ownership interest or significant management control) and related accounts receivable or payable, including assessments, loans, and guarantees may not all have been properly recorded and disclosed.

9) Intragovernmental transactions may not all have been explicitly disclosed or eliminated.

10) To the best of my knowledge, there are no:

a. Possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, that are not a matter of public record;

b. Material liability or gain or loss contingencies that are required to be accrued or disclosed, that have not been accrued or disclosed, that are not a matter of public record; or

c. Unasserted claims or assessments that are probable of assertion and that must be disclosed, that have not been disclosed.

11) To the best of my knowledge, the Department has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

12) I have no knowledge of material events or transactions that occurred subsequent to September 30, 1998, that have not been properly recorded in the Principal Statements, properly recorded in the RSSI, or disclosed in the notes thereto.

13) To the best of my knowledge, there has been no material fraud (intentional misstatements or omissions of amounts or disclosures in financial statements and misappropriation of assets that could have a material affect on the Principal Statements or RSSI) nor any fraud involving management or employees who have significant roles in internal control, that is not a matter of public record.

14) I am responsible for ensuring the establishment and overseeing the maintenance of internal controls for financial management.

15) Pursuant to the Federal Managers Financial Integrity Act, I have assessed the effectiveness of DoD's internal controls in achieving the following objectives:

a. Reliability of financial reporting--properly recording, processing, and summarizing transactions to permit the preparation of the Principal Statements and RSSI in accordance with federal accounting standards, and the safeguarding of assets against loss from unauthorized acquisition, use or disposition.

b. Compliance with applicable laws and regulations--executing transactions in accordance with (i) laws governing the use of budgetary authority and other laws and regulations that could have a direct and material effect on the financial statements, and (ii) any other laws, regulations, and government-wide policies identified by the OMB in Appendix C of OMB Bulletin 98-08; and

c. Reliability of performance reporting--properly recording, processing, and summarizing transactions and other data that support reported performance measures to permit the preparation of performance information in accordance with criteria stated by management.

16) To the best of my knowledge, the controls in place on September 30, 1998, provided reasonable assurance that the foregoing objectives were met except for the effects of material weakness discussed in the attachment.

17) I am responsible for implementing and maintaining financial management systems that comply substantially with federal financial management systems requirements contained in OMB Circular A-127, "Financial Management Systems," applicable federal accounting standards, and the United States Government SGL at the transaction level.

18) I have assessed the financial management systems to determine whether they comply substantially with these federal financial management systems requirements. Our assessments were based on criteria established under OMB Circular A-127 and guidance issued by OMB and included in Appendix D of OMB Bulletin 98-08.

19) As of the date of this letter, the Department's financial management systems do not comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the SGL at the transaction level, and did not do so as of September 30, 1998. The attachment provides information on the nature and extent of the noncompliance and the primary cause of the noncompliance.

20) I am responsible for overseeing DoD's compliance with laws and regulations applicable to the Department's financial statements.

21) I am not aware of any laws or regulations that have a direct or material effect on the determination of financial statements amounts that have not been disclosed.

22) To the best of my knowledge, I have disclosed all known instances of noncompliance with laws and regulations applicable to the Department's financial statements.

The point of contact for this matter is Ms. Gretchen Anderson. She may be reached by e-mail: andersog@osd.pentagon.mil or by telephone at (703) 697-4691.

William J. Lynn

Attachment *

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* The Attachment is the DoD FY 1998 Annual Statement of Assurance. It is located on the internet at http://www.dtic.mil/comptroller/fmfia.html

Exhibit 2. Interim Legal Representation Letter

GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
1600 DEFENSE PENTAGON
WASHINGTON, D. C. 20301-1600

GENERAL COUNSEL

4 JAN 1999

MEMORANDUM FOR THE ASSISTANT INSPECTOR GENERAL FOR AUDITING DEPARTMENT OF DEFENSE

SUBJECT: LEGAL REPRESENTATION LETTER FOR AUDITORS CONCERNING THE DEPARTMENT OF DEFENSE FISCAL YEAR 1998 DEFENSE-WIDE CONSOLIDATED FINANCIAL STATEMENTS

REFERENCES:

(a) USD(C) Memorandum dated October 29, 1998, Subject: Request for Legal Representation Letter for the FY 1998 DoD-Wide Consolidated Financial Statements

(b) DoD Directive 5145.1, dated December 15, 1989, "General Counsel, Department of Defense"

(c) DoD Directive 5145.4, dated December 15, 1989, "Defense Legal Services Agency"

(d) Statement of Federal Financial Accounting Standard No. 5, "Accounting for Liabilities of the Federal Government," September 30, 1996

(e) Department of the Army General Counsel Memorandum to the Auditor General, Department of the Army, dated December 15, 1998, Subject: Legal Representation Letter, Fiscal Year 1998, Army Litigation and Contingencies (Tab 1)

(f) Department of the Navy General Counsel Memorandum to the Auditor General, Department of the Navy, dated December 14, 1998, Subject: Legal Representation Letter for the Fiscal Year 1998 Year-End Department of the Navy General Fund Financial Audit (Tab 2)

(g) Department of the Navy General Counsel Memorandum to the Auditor General, Department of the Navy, dated December 14, 1998, Subject: Legal Representation Letter for the Fiscal Year 1998 Year-End Department of the Navy Working Capital Fund Financial Audit (Tab 3)

(h) Department of the Air Force General Counsel Memorandum to the Auditor General, Department of the Air Force, dated December 17, 1998, Subject: Air Force Audit Agency Audit of the Air Force Fiscal Year (FY) 1998 Financial Statement–Interim Report (Tab 4)

(i) Defense Logistics Agency General Counsel Memorandum to the Assistant Inspector General for Auditing, Office of the Inspector General, Department of Defense, dated December 15, 1998, Subject: Defense Logistics Agency Working Capital Fund for FY 1998 (Tab 5)

(j) Defense Finance and Accounting Service General Counsel Memorandum to the Assistant Inspector General for Auditing, Department of Defense, dated December 15, 1998, Subject: Legal Representation Letters for the FY 1998 Financial Statements of the Defense Finance and Accounting Service Working Capital Fund (Tab 6)

(k) Department of Defense General Counsel Memorandum to the Assistant Inspector General for Auditing, Department of Defense, Subject: Legal Representation Letter for Auditors Concerning the Department of Defense Fiscal Year 1998 Military Retirement Trust Fund Financial Statements (Tab 7)

(l) American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975)

This memorandum responds to reference (a) which requests that my office provide information concerning "all known litigations, claims, and assessments of $100 million or more" with respect to the DoD-Wide Consolidated Financial Statements. Reference (a) requests that two memoranda be provided. The first is an interim memorandum to be effective no earlier than December 1, 1998, and is to include matters that existed as of September 30, 1998. The second is a final memorandum that is requested to be submitted by February 19, 1999, in order to coincide with the auditor's opinion report on the DoD-Wide Consolidated Financial Statements. Reference (a) further requests information concerning unasserted claims and assessments and requests confirmation that Department legal counsel are disclosing material loss contingencies as defined in reference (d).

Known Litigation, Claims and Assessments

As you are aware, the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements covers those items which are the subject of the legal representation memoranda covered by references (e) through (k). References (e) through (j) have been submitted previously by the

Military Departments, as well as by various components of the Department of Defense and should form the basis for the required representations and evaluations for the matters covered by those memoranda. Reference (k) is being submitted to your Office contemporaneously with this memorandum and should form the basis for the required representations and evaluations for the matters covered by that memorandum. Collectively, references (e) through (k) should form the basis for the required representations and evaluations covered by all of the memoranda.

As General Counsel of the Department of Defense, I have supervisory authority only with respect to claims and litigation made against the Department of Defense and its Agencies and Field Activities (References (b) and (c)). I have obtained copies of each of the legal representation memoranda identified in references (e) through (j) and have signed the legal representation memorandum identified in reference (k) in response to a separate request for the financial statement addressed in that reference. Collectively, and subject to the time periods and other qualifications addressed in each of the legal representation memoranda, they constitute the legal representation memoranda for the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements.

With respect to those elements of the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements pertaining to matters which are administered by the Military Departments, over whose legal staffs I exercise no supervisory responsibility with respect to the subject matter of reference (a), I expressly disclaim any responsibility for the accuracy or completeness of any information reported by the legal advisors to the Military Departments.

Copies of each of the foregoing references are attached and are considered to constitute the totality of legal representation matters pertaining to the subject matter covered by the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements of the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements.

Unasserted Claims and Assessments

Reference (a) requests information concerning unasserted claims and assessments which this office considers probable of assertion and, if asserted, would have a reasonable possibility of an unfavorable outcome. I have interpreted this request to refer to unasserted claims and assessments which, if asserted, have a reasonable possibility of resulting in a material unfavorable outcome where materiality is defined as $100 million or more.

Subject to the limitations on my authority stated in references (b) and (c), to Paragraph 5, clause (a) of reference (l), and to the last paragraph of this memorandum, and the information contained in references (e) through (k), I advise you that neither I nor any of the lawyers over whom I exercise legal supervision have given substantive attention to, or provided representation in any matter covered by the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements in connection with any unasserted claims or assessments which, if asserted, would constitute a material loss contingency within the scope of clause (a) of Paragraph 5 of reference (l).

Representation Concerning Disclosure

Subject to the limitations on my authority in references (b) and (c) and to the last paragraph of this memorandum, and consistent with the last sentence of Paragraph 6 of reference (l), this will confirm that whenever, in the course of performing legal services for the Department of Defense, its Agencies or Field Activities with respect to a matter recognized to involve an unasserted possible material claim or assessment in any matter covered by the Fiscal Year 1998 Defense-Wide Consolidated Financial Statements that may call for financial statement disclosure, I or one of the lawyers over whom I exercise general legal supervision have formed a professional conclusion that the Department must disclose, or consider disclosure, concerning such possible claim or assessment, the lawyer forming such professional conclusion will so advise the Department and will consult with the Department's financial managers concerning the question of such disclosure and the applicable requirements of reference (d).

Limitation on This Response

This response is limited by, and made in accordance with, the ABA Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975) (reference (l)). Without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (paragraphs 2 and 7)) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of reference (l) and the accompanying Commentary (which is an integral part of this Statement). In addition, we do not interpret reference (a) to require or authorize the release of information subject to the attorney-client privilege or the work product doctrine, and in responding to reference (a) we have provided no information subject to that privilege or doctrine. Moreover, except as otherwise indicated in references (e) through (k), the information set forth herein is as of December 29, 1998, and covers matters that existed as of September 30, 1998 and for the period September 30, 1998 to December 29, 1998, and I expressly disclaim any undertaking to advise you of changes which may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision after the date of the final memorandum to be submitted in February, 1999. Finally, information reported herein relating to the Military Departments is reported as a courtesy and I hereby disclaim any responsibility for the accuracy or completeness of any information reported by the legal advisers of the Military Departments.

Judith Miller

Judith A. Miller

Exhibit 3. Auditor Opinion

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

March 1, 1999

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Independent Auditor's Report on the Department of Defense Agency-wide Financial Statements for FY 1998 (Project No. 8FI-2024.01)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibilities of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. We attempted to audit the FY 1998 DoD Agency-wide Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Financing, Statement of Budgetary Resources, and Statement of Custodial Activity. As the Chief Financial Officer of DoD, the Under Secretary of Defense (Comptroller) is responsible for these financial statements, for establishing and maintaining internal controls, and for complying with laws and regulations applicable to DoD financial accounting and reporting. We did not audit the Army, Navy, and Air Force financial statements for FY 1998. The Military Department audit agencies attempted to audit those financial statements and issued disclaimers of opinion.

Disclaimer of Opinion. DoD did not provide us with the FY 1998 Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Financing, Statement of Budgetary Resources, and Statement of Custodial Activity in time for us to perform all of the necessary audit work. Therefore, we did not verify the reported amounts. However, we identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines within the Statement of Budgetary Resources. Those deficiencies would have precluded an audit opinion. We also identified $1.57 trillion in adjustments to financial data used to prepare financial statements for the Army General Fund, Army Working Capital Fund, Navy General Fund, Defense Logistics Agency, and Other Defense Organizations. Those adjustments were not supported by adequate audit trails or by sufficient evidence to determine their validity.

The financial data reported on the FY 1998 Financial Statements for the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; the U.S. Army Corps of Engineers, Civil Works Program; the Defense Logistics Agency; and the Defense Finance and Accounting Service were unauditable and comprise a significant portion of the financial data reported on the DoD Agency-wide Financial Statements for FY 1998.

Because the financial statements were not provided in a timely manner and internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were not able to perform adequate audit tests of the various line item amounts reported on the financial statements. As a result, we do not express an opinion on the DoD Agency-wide Financial Statements for FY 1998.

Required Supplementary Stewardship Information. The Stewardship Statement includes National Defense Property, Plant, and Equipment; Heritage Assets; and Stewardship Land. Based on initial versions of the DoD Components' financial statements, DoD will remove approximately $618.4 billion of assets from its Balance Sheet and reclassify it as stewardship assets because of a change in accounting standards effective in FY 1998. This information is not required to be audited.

However, we applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with Federal accounting standards.

Internal Controls. The internal controls consist of the following components: control environment, risk assessment, control activities, information and communication, and monitoring. Effective implementation of these controls provides reasonable assurance that accounting data are accumulated, recorded, and reported properly by management and that assets are safeguarded. Management is responsible for internal controls. We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we do not express an opinion on the DoD internal controls.

DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 1998, the DoD Annual Statement of Assurance for FY 1998, and the DoD Biennial Financial Management Improvement Plan. A separate report discusses internal control weaknesses in further detail.

Compliance With Laws and Regulations. Our objective was to assess compliance with laws and regulations related to the DoD Agency-wide Financial Statements for FY 1998 and not to express an opinion. The scope of our work was limited because DoD did not provide us with the financial statements in a timely manner, as required by the Chief Financial Officers Act of 1990, as amended. Therefore, we do not express an opinion on compliance with laws and regulations

DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. In the Biennial Financial Management Improvement Plan, we identified several areas where DoD could improve its reporting of financial management system problems, as required by the Federal Managers' Financial Integrity Act of 1982. For example, the Biennial Financial Management Improvement Plan did not identify the deficiencies for each financial management system and did not disclose the remedies, resources, and milestones necessary to improve DoD financial management systems. In addition, DoD financial management systems and methodology for valuing inventory were not consistent with Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property, " October 27, 1993.

The results of our tests also disclosed instances where DoD financial management systems did not substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996. For example, DoD financial management systems were not integrated; did not maintain adequate audit trails; did not value and depreciate property, plant, and equipment in accordance with Statement of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," November 30, 1995; and did not incorporate the U.S. Government Standard General Ledger at the transaction level. Our work would not necessarily disclose all material weaknesses. A separate report discusses compliance issues in further detail.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

F. Jay Lane
Salvatore D. Guli
Richard B. Bird
Jack L. Armstrong
Susie R. Brittingham
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Tom P. Byers
Lynn S. Carlson
Susanne B. Allen